

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0116 IT**

**Adjusted Gross Income Tax—Net Operating Loss Deductions
For Tax Periods: 1994 through 1996**

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ISSUES

I. Adjusted Gross Income Tax—Net Operating Loss Deductions

Authority: Ind. Code § 6-3-2-2.6;
45 IAC 3.1-1-9;
26 USCA § 338;
[Taxpayer] Privatization Act, 45 U.S.C. § 1301 et seq., (1986).

Taxpayer protests proposed assessments of Indiana adjusted gross income tax based on the disallowance of net operating loss deductions for tax periods ending in 1994, 1995, and 1996.

STATEMENT OF FACTS

Taxpayer hauls freight by rail in Indiana. During the audit period (1994-1996), Taxpayer carried forward certain net operating losses (NOLs) to reduce (or eliminate) its reportable Indiana adjusted gross income. Audit disallowed these NOL deductions. Audit's decision resulted in proposed assessments of Indiana adjusted gross income tax for each year. Taxpayer protests the disallowance of its NOL deductions and the proposed assessments.

I. Sales Tax—Net Operating Loss Deductions

DISCUSSION

In response to the failure of regional rail carriers (primarily in the Northeast and Midwest), Congress passed the Regional Rail Reorganization Act of 1973 (45 U.S.C. § 701 et seq.; hereinafter, the "Act"). Among its objectives, the Act established Taxpayer, a for-profit, quasi-governmental corporation (incorporated in Pennsylvania in 1975). The United States owned eighty-five percent (85%) of Taxpayer's common stock; Taxpayer's employees owned the remaining fifteen percent (15%). Notwithstanding seven billion dollars (\$7,000,000,000) of

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(Supp.1987). (Emphasis added.) In other words, Congress, while forgiving Taxpayer's federal debt, prohibited Taxpayer from using its presale net operating losses to offset its post-sale federal income. Taxpayer—assuming continued profitability—would become a federal taxpayer. Additionally, Taxpayer's exemption from state tax liabilities was extinguished commencing January 1, 1987.

Taxpayer's state and federal post-sale tax returns (1994-1996) were reviewed by the Audit Division ("Audit) of the Indiana Department of Revenue ("Department"). Since Taxpayer, for federal income tax purposes, was prohibited from carrying forward any presale NOLs, the auditor determined a similar prohibition should apply for state income tax purposes.

Taxpayer concisely states the contested issue: "[t]he only legal issue in this matter is whether, under INDIANA law, net operating losses incurred by [Taxpayer] during periods when its stock was owned by the Federal government may be carried forward to periods after its stock was sold in a public offering [on 4/2/87]."

Taxpayer notes that for tax periods ending 4/87 through 4/89, the Department accepted Taxpayer's use of the NOL deductions now in question.

However, the focus of Taxpayer's argument concerns the methodology used in computing Indiana's net operating losses and the effects of such use. Taxpayer explains:

[T]he federal statutes involved provide only that [Taxpayer] could not carry NOL's forward for purposes of calculating its FEDERAL income tax in post-public offering tax years. The statutes are silent on whether such losses may be carried forward for STATE income tax purposes. States are free to apply their own law. Some States, by statute, specifically adopt the Federal calculation, without adjustment, as their own, and in those States no carry forward would be available for State income tax purposes. However,

other States, including INDIANA, do not precisely follow the Federal definitions or the Federal calculations but make various adjustments to reflect their own policy considerations. Thus, there is no requirement that a Taxpayer's carry forwards for INDIANA purposes be the same as its carry forwards for Federal tax purposes—they may be higher or lower and the calculations may include or exclude different items. A Taxpayer may have a carry forward for Federal purposes but not for INDIANA purposes; conversely[,] a Taxpayer may have a carry forward for INDIANA purposes but not for Federal purposes. By the same measure, carry forwards calculated under INDIANA law will differ from those calculated under the law of a different State.

For these reasons, Taxpayer contends the “original NOL carry forward’s [for tax periods ending 4/87 through 4/89] were properly computed and audited under INDIANA law [and such carry forwards should be recognized for the tax periods at issue].”

As an initial matter, the Department notes the carry forward of NOLs represents an exemption from Taxpayer's Indiana adjusted gross income. IC 6-3-2-2.6. Tax exemptions are to be strictly construed against Taxpayer (*Sony Music Entertainment, Inc. v. State Board of Tax Commissioners*, 681 N.E.2d 800,801 (Ind.Tax Ct. 1997)). Consequently, Taxpayer bears the burden of proving entitlement to the exemption (*Indianapolis Fruit Co. v. Department of State Revenue*, 691 N.E.2d 1379, 1383 (Ind.Tax Ct. 1998)). And more generally, “[t]he burden of proving that the proposed assessment is wrong rest with the person against whom the assessment is made. IC 6-8.1-5-1(b).

Ind. Code § 6-3-2-2.6 describes Indiana's four step formula used to calculate Indiana net operating losses. The preface to the state NOL computations (Ind. Code § 6-3-2-2.6(a), with emphasis added) states:

This section applies to a corporation or a nonresident person, for a particular taxable year, **if the taxpayer's adjusted gross income for that taxable year is reduced because of a deduction allowed under Section 172 of the Internal Revenue Code for a net operating loss.** For purposes of section 1 of this chapter, the taxpayer's adjusted gross income, for the particular taxable year, derived from sources within Indiana is the remainder determined under STEP FOUR of the following formula:

STEP ONE: Determine, in the manner prescribed in section 2 of this chapter, the taxpayer's adjusted gross income, for the taxable year, derived from sources within Indiana, **as calculated without the deduction for net operating losses provided by Section 172 of the Internal Revenue Code.**

STEP TWO: Determine, in the manner prescribed in subsection (b), **the amount of the taxpayer's net operating losses that are deductible for the taxable year under Section 172 of the Internal Revenue Code, as adjusted to reflect the modifications required by IC 6-3-1-3.5, and that are derived from sources within Indiana.**

- (a) General rule.—For purposes of this subtitle, if a purchasing corporation makes an election under this section (or is treated under subsection (e) as having made such an election), then, in the case of any qualified stock purchase, the target corporation—
- (1) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction, and
 - (2) shall be treated as a new corporation which purchased all of the asset referred to in paragraph (1) as of the beginning of the day after the acquisition date.

Generally, Indiana tax laws coincide with the Internal Revenue Code. (“Adjusted Gross Income’ with respect to corporate Taxpayers is ‘taxable income’ as defined in [the] Internal Revenue Code—section 63 with three adjustments...45 IAC 3.1-1-8. “‘Gross income’ for Adjusted Gross Income Tax purposes is gross income as defined in Internal Revenue Code § 61.” 45 IAC 3.1-1-19. “When used in IC 6-3, the term ‘adjusted gross income’ shall mean...[i]n the case of corporations, the same as ‘taxable income’ (as defined in Section 63 of the Internal Revenue Code) adjusted as follows...IC 6-3-1-3.5(b). See *Cooper Industries, Inc. v. Indiana Dept. of State Revenue*, 1996, 676 N.E.2d 1209. “To the extent the provisions apply to this article, regulations adopted under Section 7805(a) of the Internal Revenue Code and in effect on January 1, 1998, shall be regarded as rules adopted by the department under this article, unless the department adopts specific rules that supercede the regulation.” IC 6-3-1-11(b).)

Since Congress chose to characterize the post-sale reincarnation of Taxpayer as a “new” corporation for federal income tax purposes, Indiana will do so for state income tax purposes.

An analogous situation is noted in 45 IAC 3.1-1-9(5), which states in part:

When a corporate merger takes place or a new subsidiary is included in a consolidated Indiana Adjusted Gross Income Tax return, the Department follows the guidelines of the Internal Revenue Code as to treatment of net operating losses sustained by any of the corporations involved.

In this instance, the Department finds no reason to depart from the federal guidelines outlined in the [Taxpayer] Privatization Act (45 U.S.C. § 1301 et seq.).

The Department also notes that Taxpayer protested similar assessments proposed by the Illinois Department of Revenue. Illinois disallowed Taxpayer from carrying forward net operating losses incurred prior to the privatization of Taxpayer. In affirming the decision of the circuit court—which affirmed the Illinois Department of Revenue’s denial of Taxpayer’s NOL deductions—the Illinois Appellate Court closed with the following observation:

We are not convinced that plaintiff [Taxpayer] has met this burden in the case at bar, as plaintiff cites no authority which supports its position that, following a fundamental corporate change pursuant to section 338 election, an entity is allowed to succeed to or retain certain tax attributes, such as net losses, for state purposes when such characteristics are patently extinguished for purposes of federal taxation.

Consolidation Rail Corporation et al v. The Department of Revenue, 688 N.E.2d 806, 813 (Ill.App.3d 1997).

FINDING

Taxpayer's protest is denied.